Wage-Price Dynamics, the Labour Market and Deflation in Hong Kong

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Summary

The objective of this paper is to explain the recent deflation in Hong Kong. Since 1998 Hong Kong has experienced over 16 quarters of deflation. Some economists suggested that the Asian crisis is the reason for the recent deflation in Hong Kong. However, we show that some important asset prices such as factory and office space prices started to fall in the early 1990s, a long time before the Asian crisis, and continued to fall over our sample from 1987-2001. Others suggested that the exchange rate regime – the currency board – is probably the cause of the recent deflation. But, it is hard to explain why the deflation did not occur earlier. The currency board has been operating since 1983. Perhaps there are many factors that are lumped together and causation is going in all directions, which might explain the deflation in Hong Kong. The economists' job is to disentangle these factors. Often, this is a difficult job.

The story we tell in this paper does not depend on the Asian crisis or the currency board to explain the recent deflation in Hong Kong. It is more of a structural story. The story is about an economy that has been adjusting itself for the future. It is a well known fact in Hong Kong that firms and businesses have been leaving Hong Kong and relocating in China. However, the number of firms and businesses that have moved out of Hong Kong are not readily available. It is quite plausible that firms and businesses relocated to the Mainland because they expected future marginal costs to fall in response to Hong Kong's handover to China in 1997. The marginal cost is simply unit labour cost, which is lower in Mainland China. Products that could be manufactured more cheaply in China could also be easily moved to Hong Kong for export. So why not relocate in China?

The story is testable. The maintained model for inflation is the so-called Phillips curve, where inflation depends on expected future inflation and some measure of excess demand. In this paper we estimate a Phillips curve specification, where inflation – changes in the price level – is a function of expected inflation and the marginal cost instead, over the period 1987-2001. The marginal cost is simply unit labour cost. We compare the performance of this model with other specifications. We found that this model outperforms, in the sense that the in-and-out-of-sample forecasts, the traditional Phillips curve specification and other models of wage-price dynamics. Because the marginal cost is basically unit labour cost, the model suggests that wage and productivity dynamics play an important role in explaining price dynamics. Also, given our sample, we estimate that it takes approximately a minimum period up to three years for the price adjustments to be complete. A different up-to-date sample might give a different estimate. The point that one should keep in mind is that the adjustment is not short.

Preliminary investigation suggests that there is significant real wage rigidity in Hong Kong and that unit labour cost is an important variable to explain price dynamics in Hong Kong. While aggregate wages have not been falling, labour market adjustments seem to have been taking place in higher unemployment. Therefore, we might need to further examine wage rigidity and the dynamics of unit labour cost. Perhaps, disaggregated wage data might provide some explanations that we could not find in aggregated data.